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No. 77-275

In the Supreme Court of the United States

OCTOBER TERM, 1977

ARTHUR LIPPER CORPORATION AND ARTHUR LIPPER III, PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

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INDEX

	Page
Opinions below	1
Jurisdiction	1
Questions presented	2
Statute and rule involved	2
Statement	2
Argument	5
Conclusion	15

CITATIONS

Cases:

Ernst & Ernst v. *Hochfelder*, 425 U.S. 185	10, 11
ITT v. *Vencap, Ltd.*, 519 F. 2d 1001	13
Linden v. *United States*, 254 F. 2d 560	12
Sanders v. *John Nuveen & Co., Inc.*, 554 F. 2d 790	11
Santa Fe Industries, Inc. v. *Green*, 430 U.S. 462	5, 6, 7
Schoenbaum v. *Firstbrook*, 405 F. 2d 200, reversed in part on other grounds, 405 F. 2d 215, certiorari denied sub nom. *Manley* v. *Schoenbaum*, 395 U.S. 906	13–14
Securities and Exchange Commission v. *Kasser*, 548 F. 2d 109, certiorari denied sub nom. *Churchill Forest Industries (Manitoba), Ltd.* v. *Securities and Exchange Commission*, 431 U.S. 938	14
Securities and Exchange Commission v. *United Financial Group*, 474 F. 2d 354	14
Securities and Exchange Commission v. *Manor Nursing Centers, Inc.*, 458 F. 2d 1082	12
Straub v. *Vaisman & Co., Inc.*, 540 F. 2d 591	14
Superintendent of Insurance v. *Bankers Life & Casualty Co.*, 404 U.S. 6	6
Travis v. *Anthes Imperial Limited*, 473 F. 2d 515	13
United States v. *Schaefer*, 299 F. 2d 625, certiorari denied, 370 U.S. 917	12

251-079—77——1

Statute and rule: Page
Securities Exchange Act of 1934, 48 Stat. 881, as amended, 15 U.S.C. 78a *et seq.*:
Section 10(b) 15 U.S.C. 78j(b) 2, 3, 5, 10, 11
Section 15A(b)(6) 15 U.S.C. 78*o*-3(b)(6) 9
Securities and Exchange Commission Rule 10b-5, 17 C.F.R. 240.10b-5 ..... 2, 3, 4, 5, 6, 10, 11, 12-13
Miscellaneous:
Securities and Exchange Commission, Report of Special Study of Securities Markets H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963) 9
Securities and Exchange Commission Report to Congress on Public Policy Implications of Investment Company Growth, H.R. Rep. No, 2337, 89th Cong., 2d Sess. (1966) 8

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-26a) is reported at 547 F. 2d 171. The orders of the court of appeals denying the Commission's petition for rehearing and its suggestion for rehearing *en banc*, and the dissenting opinion from the order denying the petition for rehearing (Pet. App. 27a-30a), are reported at 551 F. 2d 915.

JURISDICTION

The judgment of the court of appeals was entered on December 10, 1976. The Commission's timely peti-

tion for rehearing was denied on March 22, 1977. On June 20, 1977, Mr. Justice Marshall extended the time for filing a petition for a writ of certiorari to and including August 19, 1977. The instant petition was filed on August 18, 1977.[1] The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether petitioners aided and abetted violations of Rule 10b–5 of the Securities and Exchange Commission when they assisted an investment adviser's scheme to defraud its mutual funds.

2. Whether the federal securities laws cover the activities of a United States broker-dealer who aided and abetted a foreign investment adviser in defrauding certain foreign mutual funds and their shareholders (including several thousand American shareholders).

STATUTE AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U.S.C. 78j(b), and Securities and Exchange Commission Rule 10b–5, 17 C.F.R. 240.10b–5, are set forth at Pet. App. 76a.

STATEMENT

After full administrative proceedings, including a lengthy evidentiary hearing before an administrative law judge, the Securities and Exchange Commission held that petitioners Arthur Lipper Corporation

[1] There is a question whether the petition was timely filed. See note 11, *infra*.

("Lipper Corp."), a registered broker-dealer in securities, and Arthur Lipper III ("Lipper"), the president and controlling stockholder of Lipper Corp., had aided and abetted violations of Section 10(b) of the Securities Exchange Act of 1934, 48 Stat. 891, 15 U.S.C. 78j(b), and Commission Rule 10b–5 thereunder, 17 C.F.R. 240.10b–5 (Pet. App. 31a–73a). The Commission revoked Lipper Corp.'s registration as a broker-dealer and barred Lipper from further association with any broker or dealer (Pet. App. 72a).

The Commission found that the petitioners had participated with IOS, Ltd., a Panamanian corporation which acted as the investment adviser to certain mutual funds, in a scheme which diverted to IOS approximately $1.4 million of the assets belonging to the mutual funds and, ultimately, to the funds' shareholders (Pet. App. 43a–45a). In 1967, the Commission entered an order expelling IOS from any direct involvement in the United States securities markets (Pet. App. 41a–42a). As a result, IOS encouraged the formation of Lipper Corp., and then relied upon it as its link to the United States securities markets and as the conduit through which IOS defrauded the mutual funds for which it served as adviser. Lipper Corp., at IOS's direction, executed securities transactions in the United States over-the-counter securities market for the IOS mutual funds (Pet. App. 42a–43a).

In these transactions, Lipper Corp. charged the mutual funds commissions that were substantially in excess of both Lipper Corp.'s costs and a reason-

able profit and then remitted 50 percent of those commissions to Investors Planning Corporation ("IPC"), an American subsidiary of IOS (Pet. App. 43a). Because of IOS's relationship to IPC, these remitted commission payments (which petitioners refer to as "give-ups") were "for all practical purposes given up to IOS" (*ibid.*). The existence of the payments was never fully disclosed either to the funds' shareholders or to their boards of directors (Pet. App. 44a–45a n. 27).

The Commission, affirming the administrative law judge, held that petitioners' role in the undisclosed remitting to IOS of $1.4 million of the mutual funds' assets constituted active and knowing participation in the perpetration of a fraud (Pet. App. 44a–45a). Relying on the administrative law judge's finding that Lipper was " 'a man intent on personal gain and willing to take the risk that the scheme by which he could reach his goal would not be found illegal' " (Pet. App. 71a), the Commission concluded (Pet. App. 72a) that "the likelihood of future misconduct by the Lipper respondents * * * [compelled] their exclusion from the securities business," and it ordered the maximum statutory sanctions.

The court of appeals affirmed the Commission's finding that petitioners had aided and abetted violations of Rule 10b–5. The court characterized the Lipper/IOS scheme as "'a bald diversion of the manager of sums belonging to the investment company" (Pet. App. 15a), and it rejected petitioners' argument that the then existing rules of the New York Stock Exchange

immunized their "conduct assisting investment company managers effectively to pocket give-ups when the funds receive nothing in return" (Pet. App. 12a). The court concluded, however, that the sanction of permanent exclusion from the securities business was "too severe" (Pet. App. 24a), and it ordered the sanction reduced to 12-month suspensions for both petitioners.[2]

ARGUMENT

1. The court of appeals correctly concluded that this was simply a garden variety fraud case, stating that "[t]he proposition that it is a fraud on the fund for a manager simply to pocket give-ups which he has diverted to himself is almost too clear for argument" (Pet. App. 10a–11a). Moreover, since the case involves customer-directed give-ups, which were abolished in December of 1968 (Pet. App. 24a), the issue is not one of general importance warranting review by this Court.

a. Petitioners contend (Pet. 9–12), however, that the decision is contrary to this Court's interpretation of Section 10(b) and Rule 10b–5 in *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462, which held that

[2] The Commission filed a petition for rehearing directed solely to the modification issue. On August 19, 1977, after rehearing on this limited issue was denied, the Commission filed a petition for a writ of certiorari (No. 77-291) challenging that ruling. The issues presented in that petition relate to the propriety of the court of appeals substituting its judgment for that of the Commission as to the sanction to be imposed and are distinct from those petitioners raise here.

a majority stockholder's effectuation of a short-form merger pursuant to Delaware law, designed to eliminate minority interests and done in alleged breach of the stockholder's fiduciary duty, did not violate Rule 10b–5.

Although both *Santa Fe* and the present case involve breaches of a fiduciary's duty, the conduct in *Santa Fe* was held to be outside the scope of Rule 10b–5 because it did not involve "any deception, misrepresentation, or nondisclosure" but was instead simply a typical case of "corporate mismanagement * * * in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary" (430 U.S. at 476–477). The Court concluded that Rule 10b–5 does not extend to mere "internal corporate mismanagement" (*id.* at 479, quoting from *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12).

The present case, in contrast, does not involve merely charges of corporate mismanagement or a majority stockholder's unfair treatment of the minority. Instead, as the court of appeals found, the petitioners took part in "a bald diversion to the manager of sums belonging to the investment company" (Pet. App. 15a), a scheme whereby "IOS and its affiliates committed a fraud on the funds by diverting to themselves, through IPC, rebates which belonged to the funds while IPC was doing nothing in return * * *" (Pet. App. 10a).

Despite petitioners' contrary contention, the court of appeals expressly found that the give-up scheme

here, unlike the corporate mismanagement at issue in *Santa Fe,* was undisclosed and unknown to the shareholders of the fund (Pet. App. 14a):

> Here IOS, through IPC, secretly pocketed the money.
>
> * * * * *
>
> Admittedly no disclosure was made directly to the boards of directors of IIT and Regent; the disclosure to the board of FOF was only that the arrangements were proper, with no attempt by independent directors to check this.

The substance of this undisclosed give-up scheme in which petitioners played a critical role was a far cry from mere corporate mismanagement. It was, instead, a contrivance to disguise kick-backs to a fiduciary of monies diverted from those to whom the fiduciary owed a special obligation of trust and confidence. Contrary to petitioners' contention (Pet. 15) that they were acting in accord with existing securities practices, this scheme bore only a surface resemblance to the give-ups common during the period in question.

At that time, the constitution and rules of the New York Stock Exchange required that its members charge certain fixed commission rates on transactions executed on that exchange, and forbade rebates (Pet. App. 3a–4a). Despite this across-the-board rule, large institutional customers, such as mutual funds, that had tremendous bargaining power became aware of the economies of scale inherent in the execution of their securities transactions, and insisted that brokers

251-079—77——2

devise a method by which they could, in effect, reduce their commission charges accordingly.

In response, the practice of "give-ups" evolved, whereby an institutional customer required a member broker to transfer a portion of the commission payments it received for exchange transactions to another member broker who had been uninvolved in the particular transaction in which this commission had been earned, but who had performed some other service for that institutional customer.[3] See Securities and Exchange Commission Report to Congress on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 162–163, 169–172 (1966). The Exchange's fixed commission schedule was technically preserved by the give-up device, since the fixed rate was charged and never returned to the customer, but the institutional customer was able to take economic advantage of its bargaining power by transferring a portion of its commission payments to third persons in return for services they had performed for the institutional investor that were unrelated to the transaction on which the commission arose.

The transactions in this case, however, took place in the over-the-counter market,[4] where there was no fixed

[3] Typically, the member broker that received the give-up was engaged in the distribution of the institutional customer's shares to the public.

[4] "Transactions in securities not taking place on an exchange are referred to as over-the-counter transactions. The over-the-counter markets, unlike the exchanges, have no centralized place for trading. * * * [A]ll registered broker-dealers are entitled to participate. The broker-dealers vary in size, experience, and function; the securities differ in price, quality, and activity." Securities and Exchange Commission, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., Pt. 2, p. 541 (1963).

commission schedule[5] that might arguably have provided either an economic—or legal—justification for give-ups.

Even more importantly, the give-up scheme in which petitioners played such a critical role was not a device designed to confer an indirect benefit on the mutual funds by permitting them to direct that part of the commission fees they paid be transferred in turn to third persons to whom the funds owed some unrelated financial obligation. Instead, the give-ups here were used to defraud the funds by enabling IOS, "simply to pocket give-ups which [it] ha[d] diverted to [it]self" (Pet. App. 10a–11a). Lipper Corp. knowingly assisted this scheme by charging its customers, the IOS-affiliated mutual funds, a commission which apparently far exceeded the cost of executing the funds' transactions at a reasonable profit, and then diverting 50 percent of those commissions to IOS itself.

[5] When Congress amended the Securities Exchange Act in 1938, it expressly prohibited national securities associations, such as the National Association of Securities Dealers (the self-regulatory entity performing the same initial oversight function for the over-the-counter market that the exchanges perform for the exchange markets) from fixing commission rates in any way. See Section 15A(b)(6) of the Securities Exchange Act, as added, 52 Stat. 1071, and redesignated, 15 U.S.C. 78*o*–3(b)(6).

Petitioners' effort to analogize these payments to exchange give-ups is an attempt to cloak with an air of legitimacy a scheme to kick-back to a fiduciary monies diverted from those to whom the fiduciary owed a special obligation of trust and confidence. As the court of appeals noted, "there was nothing in all this that should have induced a belief that give-ups could be utilized for the benefit of the adviser rather than of the fund" (Pet. App. 25a).

Petitioners actively assisted IOS in this scheme. Accordingly the court of appeals correctly rejected (Pet. App. 14a) their contention that they had no responsibility for this abuse of trust because they could not force IOS to make any disclosures to the funds; the court observed that even if petitioners could not compel disclosure "they were under no obligation to engage in conduct that would be fraudulent without it."

b. Petitioners also contend (Pet. 12–15) that the Commission's determination that they violated the law is contrary to *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, which held that scienter is an element of an action for damages under Section 10(b) and Rule 10b–5. *Hochfelder* left open the question whether scienter is also an element of an action seeking relief other than damages under those provisions.[6] It is

[6] As the court of appeals noted (Pet. App. 17a n. 6), in *Hochfelder* this Court expressly declined to reach the question "whether scienter is a necessary element in an action for injunctive relief under § 10(b) and Rule 10b–5," 425 U.S. at 194 n. 12, and this Court did not discuss the question whether scienter is an element in a disciplinary action.

unnecessary to reach that question here, however, since the court of appeals properly found that petitioners' conduct demonstrated scienter.

The court of appeals expressly assumed (Pet. App. 17a and n. 6) that *Hochfelder* required a showing in the instant case of scienter, *i.e.*, "proof of intention 'to deceive, manipulate, or defraud.'" Applying this standard, the court concluded that IOS's scheme was exactly the kind of "'cunning device'" that Section 10(b) and Rule 10b–5 proscribe. Indeed, as noted above, the court described the fraudulent nature of IOS's give-up scheme as "almost too clear for argument" (Pet. App. 11a).

The court of appeals also upheld the Commission's conclusion that respondents had been active and knowing accomplices in this scheme.[7] The court emphasized that petitioners "charg[ed] the full NYSE commission rates * * * [and] rebat[ed] half of these to IPC, a subsidiary of IOS, knowing that [it] would retain the sums paid to it although these should have been turned over to the funds directly or applied to reduce the advisory fee" (Pet. App. 18a–19a). In contrast, it empasized that other broker-dealers who made give-ups to IPC were not shown to have known of IPC's relation to IOS, or that IPC had performed no services in return for the give-ups

[7] *Sanders* v. *John Nuveen & Co., Inc.*, 554 F. 2d 790 (C.A. 7), on which petitioners also place heavy reliance, has no bearing in a case such as this, where petitioners' conduct was intentional and, indeed, pursuant to a carefully planned and meticulously executed scheme.

(Pet. App. 20a). Indeed, Lipper Corp. was created for the primary purpose of serving as IOS's link to the United States securities market, and was thus essential to IOS's fraudulent scheme (Pet. App. 3a).[8]

Although petitioners stress their reliance on "the advice of well-qualified counsel" (Pet. 15; footnote omitted),[9] the court of appeals emphasized that the advice in question came from IOS's counsel, whose "primary concern lay, as petitioners must have known, in promoting [IOS's] interests"; accordingly, the court correctly found that "petitioners could not have reasonably have thought" that their counsel was in a position to give them disinterested advice (Pet. App. 19a).

2. Finally, petitioners contend (Pet. 16–19) that this case entails an extraterritorial extension of Rule 10b–

[8] As the court of appeals correctly observed, it was not necessary to determine whether petitioners specifically knew that their conduct violated Rule 10b–5 (Pet. App. 18a–19a):

"§ 10(b) says 'Thou shall not devise any other cunning devices.' While that phrase could not be regarded as including negligence, it reads precisely on what petitioners did here—charging the full NYSE commission rates on IOS generated OTC transactions of rebating half of these to IPC, a subsidiary of IOS, knowing that IPC would retain the sums paid to it although these should have been turned over to the funds directly or applied to reduce the advisory fee. It is no answer that petitioners may not have realized that this 'cunning device' was a fraud."

[9] Such reliance is only one factor to be considered, and its significance in a particular case depends upon the circumstances. Cf., *e.g.*, *Securities and Exchange Commission* v. *Manor Nursing Centers, Inc.*, 458 F. 2d 1082 (C.A. 2); *United States* v. *Schaefer*, 299 F. 2d 625, 630–631 (C.A. 7), certiorari denied, 370 U.S. 917; *Linden* v. *United States*, 254 F. 2d 560, 568 (C.A. 4).

5 because the victims of the "deception" were the foreign investment funds (or purchasers of the shares in those funds) and that such a deceptive scheme is not subject to the federal securities laws. Petitioners also suggest (Pet. 18–19) that since the victims of the deceptive scheme were not within the United States, petitioners were not shown to have made use of "any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange" in carrying out their fraudulent scheme.

Although Lipper Corp.'s mutual fund clients were incorporated in various foreign jurisdictions, the federal courts have held uniformly that those who engage in securities transactions in the United States may not ignore the antifraud provisions of the federal securities laws when they deal with foreign customers. As the court of appeals correctly stated: "We do not think Congress intended to allow the United States to be used as a base for manufacturing fraudulent security devices for export, even when these are peddled only to foreigners" (Pet. App. 13a, quoting *IIT* v. *Vencap, Ltd.*, 519 F. 2d 1001, 1017 (C.A. 2)). To the contrary, it is well-settled that the federal securities laws apply if there has been significant conduct in the United States. See *Travis* v. *Anthes Imperial Limited*, 473 F. 2d 515, 524 (C.A. 8); accord, *Schoenbaum* v. *Firstbrook*, 405 F. 2d 200, 206 (C.A. 2), reversed in part on other grounds, 405 F. 2d 215 (*en banc*), certiorari denied *sub nom. Manley* v.

Schoenbaum, 395 U.S. 906; *Straub* v. *Vaisman & Co., Inc.*, 540 F. 2d 591, 595 (C.A. 3).[10]

The necessary nexus with activities in the United States existed in this case. As the court of appeals noted (Pet. App. 13a), the fraud was perpetrated through payments made in New York City, from one registered American broker-dealer (Lipper Corp.) to another (IPC), in connection with transactions in securities issued by American firms and traded in the United States over-the-counter market. Petitioners' part in the scheme was carried out exclusively within the United States. Moreover, some 3,000 American shareholders of one of the funds had been victimized by petitioners' acts. See *Securities and Exchange Commission* v. *United Financial Group, Inc.*, 474 F. 2d 354, 357 (C.A. 9).

The court of appeals correctly concluded that there was "no reason why the United States may not prescribe a rule for conduct within its borders even if another country having an interest might be less rigorous" (Pet. App. 14a).

[10] The Court of Appeals for the Third Circuit, in a Commission enforcement action, recently held that the federal securities laws confer jurisdiction on the federal court if "at least some activity designed to further a fraudulent scheme occurs within this country • • • [even if] the actual locus of the harm is outside • • •," *Securities and Exchange Commission* v. *Kasser*, 548 F. 2d 109, 114 (C.A. 3), certiorari denied *sub nom. Churchill Forest Industries (Manitoba), Ltd.* v. *Securities and Exchange Commission*, 431 U.S. 938.

CONCLUSION

The petition for a writ of certiorari should be denied.[11]

Respectfully submitted.

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DECEMBER 1977.

[11] If the Court should grant the petition, we reserve the right to argue that the petition was untimely because the Commission's petition for rehearing did not toll the 90-day period that petitioners had for seeking review. See pages 2, 5, and note 2, *supra*.

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